D.P.U. 95-40

Investigation by the Department on its own motion as to the propriety of the rates and charges set forth in the following tariffs: M.D.P.U. Nos. 893 through 908, filed with the Department on March 15, 1995 to become effective April 1, 1995 by Massachusetts Electric Company.

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I. INTRODUCTION

A. Procedural History

On March 15, 1995, Massachusetts Electric Company ("MECo" or "Company") filed with the Department of Public Utilities ("Department") a petition pursuant to G.L. c. 164, § 94 to increase its revenues by $62.1 million or 4.2 percent to become effective April 1, 1995. Alternatively, MECo filed an incentive regulation proposal in which the Company's revenues would increase or decrease based on a comparison of the Company's rates with the rates of other Massachusetts electric utilities. The Company projects that under its incentive plan its revenues would increase by approximately $30 million or about 2 percent to become effective October 1, 1995.[1] The Department docketed this case as D.P.U. 95-40 and on March 23, 1995, suspended the effective date of the proposed rates until October 1, 1995, pending Department investigation.

MECo supplies retail electric service to approximately 950,000 customers in 149 cities and towns in Massachusetts. The Company is a wholly-owned subsidiary of the New England Electric System ("NEES"), the parent company in a holding company system that includes: (1) three retail companies -- MECo, Granite State Electric Company, and Narragansett Electric Company; (2) New England Power Service Company ("NEPSCo"), which supplies corporate services to NEES's affiliates; and (3) New England Power Company ("NEP"), a wholesale electric generating and transmission company that supplies MECo. MECo does not own any generation facilities.

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1 Based on information that is currently available, the Company projects that its incentive proposal would result in a second revenue increase of approximately $26 million to become effective May 1, 1996 (RR-TEC-2).

Pursuant to G.L. c. 12, § 11E, the Attorney General of the Commonwealth ("Attorney General") filed a notice of intervention, and timely petitions to intervene or participate were filed by Cambridge Electric Light Company and Commonwealth Electric Company (together "ComEnergy"); Commonwealth Gas Company ("ComGas"); Conservation Law Foundation ("CLF"), Western Massachusetts Electric Company ("WMECo"); Distrigas of Massachusetts Corporation ("Distrigas"); the Energy Consortium ("Energy Consortium"); the Industrial Intervenors ("Industrial Intervenors"); Irving Burstein, Pearl Noorigan and Jeannie Stephenson ("Low-Income Intervenors"); and Milford Power Limited Partnership ("Milford Power"). Late-filed petitions to intervene were filed by Wheeled Electric Power Company ("WEPCo") and Jane Walton, a ratepayer of Nantucket Electric Company. The Hearing Officers noted the Attorney General's intervention as of right pursuant to G.L. c. 12, § 11E, and allowed CLF, the Energy Consortium, the Industrial Intervenors, Distrigas, the Low-Income Intervenors, and MPLP to participate as parties. In addition, the Hearing Officers granted Jane Walton the right to participate as a limited participant for the purpose of submitting comments or briefs. Finally, the Hearing Officers allowed ComEnergy, ComGas, WMECo, and WEPCo to participate as limited participants for the purpose of submitting comments or briefs relating the Department's review of the Company's incentive plan.

B. <u>Request For Comments</u>

On April 20, 1995, the Department conducted a prehearing conference at which a procedural schedule was established. Pursuant to the procedural schedule and notice duly issued, the Department conducted evidentiary hearings on the incentive proposal on May 11 and May 12,

1995. In support of its filing, the Company submitted the prefiled testimony and related exhibits of one witness, Lawrence J. Reilly, vice president and director of rates for NEPSCo.

At the conclusion of the evidentiary hearings on May 12, 1995, the Department indicated that the Department would consider an order on the incentive proposal and contemplated setting a briefing schedule specifically on the incentive proposal. The Attorney General stated that a bifurcation of the rate and incentive plan proceedings was not feasible as the merit of the incentive proposal is linked to a determination of the revenue requirement (Tr. 2, at 26). In addition, the Attorney General stated that its limited resources posed additional obstacles to implementing a briefing schedule on the incentive plan at a time when it was preparing for the rate proceeding (id.). CLF agreed with the Attorney General (id.). Milford Power also asserted that the incentive plan and a revenue requirement could not be severed (id.). MECo stated that it would comply with any schedule established and that litigation of cost of service issues would not be necessary if the Department accepted the incentive rate proposal (id.). On May 18, 1995, CLF submitted comments in opposition to a separate briefing schedule; on May 19, 1995, the Low-Income Intervenors submitted similar comments.

On May 19, 1995, the Department issued a Request for Comments limited to the incentive mechanism of the Company's proposal.[2] Initial comments were submitted on June 2, 1995 by the Attorney General, CLF, ComEnergy, the Company, the Energy Consortium, the Industrial Intervenors, the Low-Income Intervenors, Milford Power, and Jane Walton. Reply comments were submitted by June 9, 1995 by the Attorney General, the Company, and Milford Power.

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[2] On May 23, 1995 the Department issued a Revised Request for Comments.

Pursuant to the established procedural schedule as amended, initial briefs were submitted on July 18, 1995 by the Attorney General, CLF, the Low-Income Intervenors, the Energy Consortium, and Jane Walton.[3] The Company's reply brief is due August 2, 1995 and thus is not represented in this Order.

II. DESCRIPTION OF THE COMPANY'S INCENTIVE PROPOSAL

The Company's incentive proposal would establish a rate benchmarking mechanism under which incentive payments and penalties would be determined based on a comparison of the Company's average rate with the weighted average rate charged by all other Massachusetts electric utilities (the "benchmark rate") (Exh. MECo-1, exh. LJR-2, at 1-2).[4] The average rate for MECo and the other utilities would be determined by dividing each company's Total Revenue from Ultimate Customers by its Total KWH Sales to Ultimate Customers (id. at 2-3).[5] The proposal would be in effect for a five-year period, through May 1, 2000, with the option for the Company or the Department to terminate the proposal on or after May 1, 1997, by giving no less than one year's notice (id. at 1). Generally, changes in the Company's rates would take effect as of May 1 of each year (Exh. MECo-1, at 8). However, the first rate change would take effect on

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3 The briefs submitted by the Attorney General, CLF, the Low-Income Intervenors, and the Energy Consortium discussed the incentive plan.

4 The benchmark group would consist of seven investor-owned electric utilities and 40 municipal electric utilities. Each utility's average rate would be weighted in proportion to its level of KWH sales (Exh. MECo-1, exh. LJR-1).

5 A company's Total Revenue from Ultimate Customers is reported on the Federal Energy Regulatory Commission ("FERC") Form 1, page 300, column (b), line 10 (Exh. MECo-1, exh. LJR-2, at 2). A company's Total KWH Sales to Ultimate Customers is reported on the FERC Form 1, page 301, column (d), line 10 (id.).

October 1, 1995 (id.).

For each year that the proposal is in effect, the Company would submit a report to the Department on April 15 with calculations supporting any incentive payment or penalty that would apply over the twelve-month period beginning May 1 (id. at 7).[6] If MECo's average rate for the previous year were less than the benchmark rate, it would be entitled to receive an incentive payment that would be calculated as the product of (1) 20 percent of the difference between MECo's average rate and the benchmark rate,[7] and (2) its Total Revenue from Ultimate Customers (Exh. MECo-1, exh. LJR-2, at 4). The revenue increase due to the incentive payment for a given year would be capped at the growth rate in the Consumer Price Index (id. at 5).[8] The incentive payment would be allocated to each rate class based on each class's KWH sales as a percentage of Total KWH Sales to Ultimate Customers (id. at 6).[9] If the Company were to accept the incentive payment, it could not petition the Department for an increase in either its base rates or its Purchased Power Cost Adjustment ("PPCA") which would become effective on or

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6 The FERC Form 1 filings are due at the Department on April 1 of each year. The April 15 filing date for the Company's report provides the Company with 15 days to compile its report (Exh. MECo-1, at 7).

7 The difference between the Company's average rate and the benchmark rate would be expressed in percentage terms. It would be calculated as (benchmark rate - MECo rate)/benchmark rate (Exh. MECo-1, exh. LJR-2, at 4).

8 The Consumer Price Index for all Urban Consumers, U.S. City Average, as reported by the U.S. Department of Labor, Bureau of Labor Statistics (Exh. MECo-1, exh. LJR-2, at 5).

9 The Company stated that it would periodically submit revenue neutral, rate design filings in order to allocate the incentive payments based on a cost-of-service study consistent with the Department's cost allocation principles (Exh. MECo-1, at 14).

before May 1 of the following year (id. at 4). The Company could alternatively choose not to accept the incentive payment and instead retain the option to petition the Department for increases in its base rates and PPCA that would become effective on or before May 1 of the following year (id. at 6).

If MECo's average rate were to exceed the benchmark rate, it could be subject to a penalty that would be calculated as the product of (1) 20 percent of the difference between MECo's average rate and the benchmark rate, and (2) its Total Revenue from Ultimate Customers (id. at 4-5). The revenue decrease due to the penalty would be capped at an amount equal to three percent of the Company's average common equity for the previous year (id. at 5). However, the penalty would be imposed only if the Company petitioned the Department for a base-rate increase which would become effective on or before May 1 of the following year (id.). If the Company did not petition the Department for such an increase, no penalty would be applied (id.).

The Company would continue to file for reconciling adjustments under its existing Fuel Adjustment Clause and Conservation Cost Factor mechanisms (id. at 6).

III. STANDARD OF REVIEW

In its investigation into incentive regulation, the Department established the standard of review that would be applied to incentive proposals and the criteria by which these proposals would be evaluated. Incentive Regulation, D.P.U. 94-158, at 52-66 (1995) ("D.P.U. 94-158"). The Department stated that, because incentive regulation would act as an alternative to traditional cost-of-service regulation, incentive proposals would be subject to the standard of review established by G.L. c. 164, § 94, which requires that rates be just and reasonable. Id. at 52. A petitioner seeking approval of an incentive proposal would be required to demonstrate that its approach is more likely than current regulation to advance the Department's traditional goals of safe, reliable and least-cost energy service and to promote the objectives of economic efficiency, cost control, lower rates, and reduced administrative burden in regulation. Id. at 57.

The Department further stated that well-designed incentive mechanisms should provide utilities with greater incentives to reduce costs than currently exist under traditional cost-of-service regulation and should assign benefits to customers, whether in the form of lower prices or increased service, that improve on what would have been offered under current regulation. Id. at 54-55. The Department added that a well-designed incentive plan should provide a utility with the opportunity to earn greater rewards in exchange for the assumption of greater risk. Id. at 57.

In addition to these general criteria, the Department established more specific criteria that would be used in evaluating incentive proposals. These criteria require that incentive proposals:

> (1) must comply with Department regulations, unless accompanied by a request for a specific waiver. The Department added that incentive proposals that comply with statutes and governing precedent were strongly preferred;
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> (2) should be designed to serve as a vehicle to a more competitive environment and to improve the provision of monopoly services. Incentive proposals should avoid the cross-subsidization of competitive services by revenues derived from the provision of monopoly services;
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> (3) may not result in reductions in safety, service reliability or existing standards of customer service;
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> (4) must not focus excessively on cost recovery issues. If a proposal addresses a specific cost recovery issue, its proponent must demonstrate that these costs are exogenous to the company's operation;

> (5) should focus on comprehensive results. In general, broad-based proposals should satisfy this criterion more effectively than narrowly-targeted proposals;
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> (6) should be designed to achieve specific, measurable results. Proposals should identify, where appropriate, measurable performance indicators and targets that are not unduly subject to miscalculation or manipulation; and
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> (7) should provide a more efficient regulatory approach, thus reducing regulatory and administrative costs. Proposals should present a timetable for program implementation and specify milestones and a program tracking and evaluation method.
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> Id. at 58-64.

IV. SUMMARY OF PARTIES' COMMENTS

A. Introduction

The Department presents the summary of the parties' comments in two sections. First, the general comments regarding the Company's proposal are summarized. Second, the comments related to the issues specified by the Department in the May 23, 1995 Revised Request for Comments are summarized.

B. General Comments

The Company cites three reasons why its proposal would provide greater benefits to ratepayers than would be provided through traditional cost-of-service regulation (Company Initial Comments at 2). First, the Company claims that the proposal would moderate the $62 million rate increase that otherwise would be justified in this case (id. at 2). Second, it states that the proposal would hold the Company's overall rate increase in 1995 and 1996 to approximately two percent, well below the projected 1995 rate of inflation (id.). Thus, the proposal would implement a "significant productivity offset to inflationary increases in the near term" (id.). Third, the Company asserts that the proposal uses an objective, independent and easily calculated benchmark based on neighboring firms that do business in the same area as the Company (id. at 3). As such, the proposal represents a concrete practical step away from pricing based on MECo's costs and toward market driven pricing (id.).

All of the other parties that submitted comments identify deficiencies in the Company's proposal and assert that it does not meet the criteria established by the Department in D.P.U. 94-158 (Attorney General Comments at 5; Energy Consortium Comments at 4-5; Milford Power Initial Comments at 1-2; CLF Initial Brief at 2; Industrial Intervenors at 4; ComEnergy Comments at 6-7; Low Income Intervenors Comments at 3; Jane Walton Comments at 1).

The Attorney General asserts that the Company has failed to demonstrate that its proposal is more likely than traditional regulation to meet the Department's regulatory goals and objectives (Attorney General Comments at 4). He recommends that the Department (1) dismiss the Company's proposal, (2) set a just and reasonable revenue requirement for the Company in its ongoing rate case proceeding, and (3) order the Company to file a new incentive proposal that is consistent with the Department's decision in D.P.U. 94-158 (id. at 5).

Milford Power states that the proposal is "flawed" because the mechanism is principally structured as a set of interim rate increases that would "drive" the Company's rates toward the higher rates of other Massachusetts electric companies (Milford Power Initial Comments at 1-2). It asserts that the proposal thus fails to provide meaningful motivation for the Company to improve its performance and lower its costs (id.).

CLF maintains that, under the Company's proposal, it would receive twice the financial benefit by discontinuing its DSM activities than it would by continuing these activities (CLF Initial

Brief at 8). CLF asserts that, as such, the proposal would create "unnecessary disincentives to continued utility investments in conservation and load management programs" (id. at 2). CLF states that the Department should reject the Company's proposal and should direct the Company to "modify its proposal to ensure that it is at least neutral towards future conservation investment" (id. at 11).

The Low Income Intervenors assert that the Company's proposal "starts with too high a base, reflects too large an inflation index, reflects too small a productivity index, lacks proper exogenous factors, and will not impose the discipline of performance on MECo" (Low Income Intervenors Comments at 3).

The Energy Consortium asserts that the Company's proposal does not conform to the requirements established in D.P.U. 94-158 and should be rejected (Energy Consortium Comments at 4-5). It adds that it "does not support the continued implementation of the fuel clause," arguing that there is no "requirement of a fuel clause in G.L.c. 164, § 94G" (id. at 2-3). It argues that "any incentive approved by the Department should be conditioned on cancellation of the fuel clause" (id. at 3).

C. Comments Addressing Issues Specified in Request for Comments

1. Annual Option to File for a Base Rate and PPCA Increase

MECo asserts that the provision in its proposal that allows the Company to reject the incentive payment and instead file for an increase in its base rates "provides a flexible way to allow for adjustments for exogenous factors without defining these factors in advance" (Company Initial Comments at 4). It adds that this flexibility "eliminates the need to define these exogenous factors in advance or to experience unreasonable earnings before filing to correct them" (id. at 5). The Company contends that, as such, the proposal "allows the Company to maintain its financial integrity when events do not turn out as projected" (id.). The Company further asserts that the "right to file based on a cost of service or some other earnings floor protection is necessary to maintain regulatory accounting" for the Company (id.). Finally, the Company argues that, under its proposal, "the decision to file for a rate increase is changed significantly, and the likelihood of a rate case is substantially reduced." This is because (1) the Company would weigh the benefits of an immediate and known incentive payment against a delayed and uncertain base rate increase that would require significant management resources, and (2) if the Company were to file a rate case, it would be "admitting defeat under the incentive program" (id. at 6-7). The Company stated that, as such, it "expects to live within the defined revenue stream, and manage within the agreed upon prices," thus creating the appropriate incentive for more efficient management behavior (id. at 7).

Most of the other parties argue that, because the proposal allows the Company to file annually for an increase in its base rates and PPCA, the proposal provides little incentive for the Company to control its costs through efficient management behavior (Attorney General Comments at 5-6; Energy Consortium Comments at 2; Milford Power Initial Comments at 2-3). The Attorney General argues that this annual option does not create a positive incentive over traditional regulation because, if the Company's "self-determined budget becomes too tight, rather than increase efficiency, it can simply opt out" (Attorney General Comments at 7).

The Energy Consortium states that it does not support the Company's option to file for annual increases in its PPCA (Energy Consortium at 2). The Energy Consortium asserts that the

Company's only option should be to file a full base rate case that would include all costs and expenses (id.).

Milford Power argues that the Company's annual option to file for a base-rate increase and/or PPCA increase assures that the proposal is a "no-lose" proposition for the Company (Milford Power Initial Comments at 2-3). As such, the proposal provides little incentive for improved performance (id.). Milford Power contends that an effectively-designed incentive proposal should "place limits on a company's ability to file for general rate increases during the incentive period unless a revenue deficiency exceeds some trigger point" (id. at 3-4).

2. Selection of the Benchmark Group

MECo asserts that keying its incentive to the average price of other Massachusetts electric utilities is appropriate because these utilities (1) "provide a comparable service to comparable customers in a comparable place facing the same tax, environmental, and regulatory policies," and (2) "represent a large enough sample of companies, managements, corporate organizations, and pricing systems to create an independent benchmark for pricing within the state" (Company Initial Comments at 7-8).

Most of the other parties argue that the use of Massachusetts electric utilities as the benchmark group is inappropriate. The Attorney General states that, although the use of a state average does have the advantage of subjecting MECo to incentives based on a similar operating environment, the competition MECo faces does not come from within Massachusetts but from other states (Attorney General Comments at 8). The Attorney General thus asserts that, if "an incentive is to be based on a benchmark rate, MECo should be using a national rather than a statewide average and that specific goals should be set regarding rate movement toward the national average rate" (id.).

The Energy Consortium states that a benchmark of the national average rate would be "desirable and appropriate" (Energy Consortium Comments at 3). It adds that the average rate of other Massachusetts utilities could be used if the incentive were based on improvements in the Company's rate compared to improvements in the benchmark rate (id.).

Milford Power asserts that rate level comparison should be done among companies of comparable size and service territory characteristics (Milford Power Initial Comments at 6). It adds that the companies included in the benchmark group are too dissimilar in size and service territory characteristics for an overall rate level comparison (id.).

The Industrial Intervenors contend that, because Boston Edison exerts an "overwhelming" influence on the benchmark rate, the proposal essentially compares MECo's rates with those of Boston Edison (Industrial Intervenors Comments at 5-7). The Industrial Intervenors argue that this is an inappropriate comparison because, Boston Edison is an integrated utility with ownership of generation, transmission, and distribution assets, and MECo is an all-requirements customer of New England Power with no generation and few transmission assets (id.). The Industrial Intervenors contend that a more appropriate group of benchmark utilities would be utilities located in the Northeast, including those located in Pennsylvania, New York, and Maryland (id. at 7-8). Alternatively, MECo could use itself as a benchmark by comparing its performance in the future with its performance in the past (id. at 8).

3. Incentive Based on the Difference Between the Company's Rates and the Benchmark Rate

The Company contends that, because its proposal allows increases "only as long as and to the extent that it maintains a price advantage," the proposal sends "precisely the correct signal to stimulate long run efficiency gains" (Company Initial Comments at 10). The Company adds that because the inflation cap assures that no increases will occur in real terms without a full cost of service filing, the proposal will force improvements in the Company's productivity for it to realize reasonable earnings (id.).

Most of the other parties assert that, for a rate benchmarking mechanism to provide the proper incentives, the proposal must focus on future, rather than past performance. The Attorney General argues that incentives should be based on improved performance, not on maintaining the status quo for past achievements. He asserts that incentives should be awarded based on "movement toward low cost producers, not based upon maintaining the Company's position vis-a-vis high cost providers" (Attorney General Comments at 9).

The Energy Consortium asserts that a utility should be entitled to an incentive rate increase only if there is improvement in the relative position of the Company's average rate to a benchmark rate of other Massachusetts utilities and/or other utilities in the United States (Energy Consortium Comments at 3). It adds that the Company's proposal provides little incentive for management efficiency because the Company is "almost guaranteed" a significant rate increase in each year because of the current relationship between its average rate and the average rate of the other Massachusetts utilities (id. at 2).

Milford Power asserts that incentive ratemaking is "properly prospective and should proceed from a starting point that has neither a revenue deficiency nor a revenue excess" (Milford Power Initial Comments at 7). It adds that the Company's proposal "principally rewards past performance; only cost pass-through expenses are subject to an incentive for savings" (id. at 9-10).

ComEnergy states that, because the Company would be entitled to an incentive for maintaining the status quo, the proposal "appears to provide a reward to the Company without a corresponding benefit to customers and without any increase in existing levels of efficiency" (ComEnergy Comments at 5).

4. Consistency Of Rate Benchmark Approach With D.P.U. 94-158

The Company asserts that its proposal is consistent with all of the criteria established in D.P.U. 94-158 (see Exh. MECo-1, at 15-20). In addition, the Company states that its proposal is "consistent with, but more stringent than, the price cap model of inflation less productivity" approved by the Department in the NYNEX order (Company Initial Comments at 11).

The Attorney General states that a rate benchmark incentive mechanism would have merit if the incentives were based on how well a company reduces its average prices for all customers and moves toward the national average (Attorney General Comments at 9).

Milford Power states that it is not clear "whether an overall rate level comparison is the appropriate benchmark to be measured" (Milford Power Initial Comments at 6).

ComEnergy suggests that the Department "should carefully assess whether it is appropriate to rely on the single benchmark statistic in deciding the relative performance of companies" (ComEnergy Comments at 4-5). It further asserts that the Company's proposal "provides little direct reward for utility performance since the only comparative measure is revenue per KWH" (id. at 6). ComEnergy asserts that, although the Company's proposal appears to satisfy several of the Department's criteria (e.g., consistent with Department regulations, statutes, and governing precedent, and with accounting standards; administratively simple), the proposal does not complement the ongoing movement toward a more market-based utility framework (id.). Further, ComEnergy contends that the proposal does not directly address system integrity and reliability (id.).

V. ANALYSIS AND FINDINGS

As an initial matter, the Department acknowledges that the incentive proposal filed by the Company is the first such proposal submitted for Department review subsequent to the issuance of D.P.U. 94-158. The Department commends the Company's efforts to design an incentive proposal. However, the Department has identified several deficiencies in the proposal.

The most significant deficiency in the Company's proposal is that it would not provide the Company with sufficient incentives to improve its future performance through increased efficiencies. In D.P.U. 94-158, at 40, the Department stated that "the primary objective of incentive regulation should be to provide marketplace benefits to consumers by promoting more efficient utility operations, cost control, and opportunities for reduced electric and gas rates .... incentive regulation should also provide an opportunity for each electric and gas company to adjust to competition as it develops." To achieve these objectives, an incentive proposal should reward or penalize a company based on its ability to outperform, during the term of the proposal, a specified benchmark that establishes a sufficiently high standard of performance so that a company would be rewarded only for above-average performance and would be penalized for below-average performance. The Company's proposal fails to do this on two accounts.

First, the proposal would use the average rate of other Massachusetts electric utilities as the benchmark against which the Company's average rate would be evaluated. Because MECo has already demonstrated its ability to keep its rates at levels below the rates charged by the other Massachusetts utilities, the Department is not convinced that a benchmark that reflects the average rate of these utilities would set a sufficiently high standard of performance. The Department agrees with those commenters that stated that a more appropriate benchmark would be the rates of electric companies, both regional and nationwide, that are of comparable size and service territory characteristics to the Company and that the Company uses as a comparison group for other purposes (e.g., companies included in the Company's return-on-equity analysis).[10]

Second, and even more critically, the structure of the Company's proposal is such that the Company would be rewarded for simply maintaining the difference that currently exists between its average rate and the benchmark rate. As such, the Company would be rewarded as much for the results of its historic operation as for its future performance. The Department finds this to be inconsistent with the objectives stated above. A proposal that based the Company's incentive payments and penalties on its ability to widen the differential that currently exists between its average rate and the benchmark rate could provide the necessary incentive for the Company to

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10 As noted in Section IV.C.2, above, the Attorney General and the Energy Consortium recommended that a benchmark reflect the nation-wide average rate. The Industrial Intervenors recommended using a region-wide (i.e., utilities located in the Northeast) average rate or, alternatively, the Company's historic operation as a benchmark. Milford Power recommended that a benchmark reflect the average rate of companies that are of comparable size and service territory characteristics to MECo.

achieve increased efficiencies in the future which is not provided by the current proposal.

A third deficiency in the Company's proposal is the failure to strike an appropriate balance between potential rewards and risks, primarily because it would provide the Company with the annual option of petitioning the Department for an increase in its base rates and PPCA.[11] In D.P.U. 94-158, at 57, the Department stated that "a well-designed incentive proposal should provide a utility with the opportunity to earn greater rewards in exchange for the assumption of greater risk." Because the proposal would allow the Company to determine annually whether it would be better served by accepting the incentive payment or by filing for a rate increase,[12] it is not clear that the Company would assume any risk in return for the possibility of earning increased profits. The Department finds this lack of balance between risks and rewards to be unacceptable. At a minimum, an incentive plan should require that a company assume the risk associated with increases in those costs that are within its control. As such, a proposal should establish revenue or price limits under which a company would be required to operate. If a company proposes to treat costs that are beyond the control of a company (i.e., exogenous costs) in a different manner, it must "affirmatively demonstrate the necessity" of doing so. Id. at 62.

A fourth deficiency in the Company's proposal is the omission of any provisions that would address safety, service reliability, or customer service. The Department has stated that

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11 A second example of the proposal's uneven treatment of potential rewards and risks is that a penalty would not be automatically imposed upon the Company if its average rate were to exceed the benchmark rate. This contrasts with the automatic incentive that the Company would be entitled to if its average rate were less than the benchmark rate.

12 This assumes that the Company's average rate remains below the benchmark rate.

"[w]hile the primary focus of an incentive proposal should be to achieve cost reductions, the Department continues to recognize its mandate to ensure the continued delivery of safe and reliable service to the public .... The Department will not accept incentive proposals that result in reduced safety ..." Id. at 60. The Company testified that, to the extent that there were "serious problems" regarding these areas, the problems would appropriately be addressed by the Department as part of its broad oversight authority (Tr. 1, at 99-100). The Department rejects this argument. To the extent possible, proposals should include clearly defined benchmarks by which a company's safety, service reliability and customer service performance would be evaluated.

Based on the above analysis, the Department finds that the Company has not demonstrated that its proposal is more likely than current regulation to advance the Department's traditional goals of safe, reliable and least-cost energy service and to promote the objectives of economic efficiency, cost control, lower rates, and reduced administrative burden in regulation. Therefore, the Department rejects the Company's proposal. However, the Department strongly encourages the Company to submit a new incentive proposal that is consistent with the standard of review and the evaluation criteria established in D.P.U. 94-158 and the direction provided in this Order. Such a proposal could be based on a rate benchmarking mechanism with appropriate adjustments or, alternatively, it could be based on an entirely different incentive mechanism (e.g., a price cap).

The Department notes that a properly-designed rate benchmarking incentive mechanism could be consistent with the evaluation criteria established in D.P.U. 94-158. First, such a mechanism should be in compliance with the Department's regulations, existing statutes, and governing precedents and, thus, could be implemented without undue delay. Second, a rate benchmarking mechanism could incorporate well-defined, measurable indicators of performance that are not unduly subject to miscalculation or manipulation and that are readily available. Third, a well-designed rate benchmarking mechanism could reduce regulatory and administrative costs. Fourth, because such a mechanism relies on a company's overall rates, it would represent, in general, a comprehensive rather than narrowly-focused approach to controlling costs and improving service. The Department recognizes that, because the Company's incentive payment would be affected by the Company's fuel procurement performance vis-a-vis the benchmark group, the current proposal does provide the Company with some incentive to manage its fuel procurement efficiently. However, because fuel expenses would remain fully reconcilable under the current proposal (i.e., recovered by the Company on a dollar-for-dollar basis), the incentive that currently exists for the Company to make trade-offs between fuel expenses and non-reconcilable expenses (e.g., operation and maintenance) would persist.[13] Therefore, the Department encourages all companies to develop even broader incentives for efficient fuel procurement, consistent with G.L. c. 164, § 94G.[14]

Finally, the record shows that several of the deficiencies identified in this Order stem from

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[13] The Department notes that almost 30 percent of the Company's total revenues are associated with fuel expenses (Exh. DPU-1-25).

[14] The Department previously has approved creative efforts to adapt the implementation of G.L. c. 164, § 94G to an increasingly competitive electric industry. See Boston Edison Company, D.P.U. 94-1D (1994); Commonwealth Electric Company, D.P.U. 94-3A (1994).

the fact that the Company's proposal was designed, in large part, to recover the revenue shortfall requested by the Company in its current rate filing. The Department has stated that "[a]n important step in developing a well-designed price cap is determining just and reasonable rates for the starting point under price regulation." New England Telephone and Telegraph Company, D.P.U 94-50, at 273 (1995). This principle applies to incentive regulation in general. The Department expects that, by using the revenue requirement determined in its rate case as the "starting point" for its incentive proposal, the Company should be able to address the identified deficiencies by: (1) using a benchmark rate that establishes a sufficiently high standard of performance so that a company would be rewarded only for above-average performance and would be penalized for below-average performance;[15] (2) rewarding and penalizing the Company based on its future performance vis-a-vis a specified benchmark rate; (3) including an appropriate balance between potential rewards and risks; and (4) including provisions that address safety, service reliability, and customer service.

VI. ORDER

Accordingly, after due notice, hearing, and consideration, it is

ORDERED: That the incentive proposal filed by Massachusetts Electric Company on March 15, 1995 be and hereby is rejected without prejudice to submit an incentive proposal consistent with this Order and with D.P.U. 94-158.

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15 Although the Company is not precluded from using a benchmark group that would be limited to Massachusetts electric companies, the Company must demonstrate that any proposed benchmark group would establish a sufficiently high standard of performance to receive Department approval.

By Order of the Department,

Kenneth Gordon, Chairman

Mary Clark Webster, Commissioner

Janet Gail Besser, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal may be filed with the Secretary of the Commission within twenty days after the date of service for the decision order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of Said Court.
(Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).